

**WATER/RSK/BMD/JB5/AJT/drs**

**Proposed**

**PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

**DIVISION OF WATER AND AUDITS**

**Water and Sewer Advisory Branch**

**RESOLUTION W-4945**

**April 4, 2013**

**R E S O L U T I O N**

**(RES. W-4945), SAN GABRIEL VALLEY WATER COMPANY (SAN GABRIEL) ORDER SEEKING AUTHORIZATION TO ESTABLISH THE INCOME TAX REPAIR REGULATIONS IMPLEMENTATION MEMORANDUM ACCOUNT (ITRRI-MA) TO TRACK THE COSTS ASSOCIATED WITH THE IMPLEMENTATION OF NEW TAX RELATED REPAIR REGULATIONS.**

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**SUMMARY**

By Tier 2 Advice Letter 423, filed on January 14, 2013, San Gabriel Valley Water Company (San Gabriel), a Class A water utility, seeks authorization to establish the Income Tax Repair Regulations Implementation Memorandum Account (ITRRI-MA). The purpose of the ITRRI-MA is to track the costs the utility will incur, including setting up the necessary accounting systems and obtaining any other outside services needed, in order to implement new tax regulations relating to the tax treatment of repairs that federal agencies issued in December 2011 and March 2012. This Resolution authorizes San Gabriel to establish the ITRRI-MA for the limited purpose of tracking associated necessary costs incurred in order to allow the utility to be able to implement these new regulations. These regulations are effective and would provide significant tax benefits to San Gabriel and its ratepayers, if San Gabriel were able to implement them with respect to repairs it conducts. Accordingly, it is in the interest of San Gabriel and its ratepayers for the utility to put in place the necessary changes to the accounting systems as soon as possible to begin implementing these new repair regulations. The goal is for San Gabriel to have all needed systems in place so that it can begin implementing these regulations.

San Gabriel may track appropriate costs incurred, for the reasons discussed above, after the ITRRI-MA becomes effective.

**BACKGROUND**

On August 21, 2006, the Internal Revenue Service (IRS) and the U.S. Treasury Department published in the Federal Register (71 FR 48590-01) proposed amendments to the Internal Revenue Code relating to “amounts paid to...improve tangible property.” After receiving written comments and holding a public hearing, the IRS and the Treasury Department withdrew the 2006 proposed regulations on March 10, 2008, and proposed new regulations

(73 FR 47 12838-01) relating specifically to the deduction of items for business expenses and the capitalization requirement. Subsequent public comment was considered and incorporated into a final package of regulations.<sup>1</sup>

The Treasury Department issued these final regulations (T.D. 9564) on December 23, 2011, and the IRS issued related guidance in March 2012. Section III of T.D. 9564 entitled “Repairs Under §1.162-4” states:

The 2008 proposed regulations proposed to revise §1.162-4 (the repairs regulation)...(and) provided that amounts paid for repairs and maintenance to tangible property are deductible if the amounts paid are not required to be capitalized under §1.263(a)-3...The proposed regulations...clarify that a taxpayer is permitted to deduct amounts paid to repair and maintain tangible property provided such amounts are not required to be capitalized under section 263(a) or any other provision of the Code or regulations.

The IRS or the California Franchise Tax Board (FTB) may issue further guidance on these matters in the future. The regulations and guidance (collectively, “repair regulations”) provide for several tax accounting changes, one of which accelerates the recovery of repair costs for tax purposes. Repair costs, which are normally capitalized, would now be treated as expensed items. Consequently, when San Gabriel implements the repair regulations, it is anticipated that San Gabriel will claim a significant net income tax deduction.

Unless the corresponding deferred tax effects are recorded on a normalized basis that adjusts rate base, the anticipated net tax benefit from the repair regulations prior to the next GRC will not be preserved for ratepayers. San Gabriel will fully normalize the effects as they are realized in accordance with the normalization requirements of the Internal Revenue Code. As San Gabriel records normalized deferred taxes in rate base during the years of the current GRC, ratepayers may also realize a benefit in the attrition year filings. In addition, ratepayers will benefit from the repair regulations in the next GRC with rate base in the 2015 test year reflecting normalized deferred tax consequences of the repair regulations in pre-2015 years.

The purpose for establishing the ITRRI-MA is to reconcile the timing disconnect between the need to incur costs now in order to implement the repair regulations as soon as possible. These costs will be tracked in the ITRRI-MA each month and will be subject to a reasonableness review as part of San Gabriel’s next GRC.

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<sup>1</sup> Department of the Treasury, “Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property,” 76 Federal Register 248 (December 27, 2011), pp. 81060 – 81127.

## **NOTICE AND PROTESTS**

Advice Letter (AL) 423 was served on January 13, 2013, in accordance with General Order 96-B, on adjacent utilities and persons on the general service list. No protests were received. Customer notice is not required because this advice letter is not requesting higher rates or charges, or more restrictive terms or conditions, than those currently in effect.

## **DISCUSSION**

San Gabriel requests authorization to modify its Preliminary Statements to add Part CCC attached to this Resolution, and establish the ITRRI-MA to track the costs, including outside implementation service fees and required accounting system changes associated with the implementation of recently issued repair regulations.

## **Definition and Tier Classification**

A memorandum (memo) account, as defined in paragraph 6 of the Commission Standard Practice U-27-W, Standard Practice for Processing Rate Offsets and Establishing and Amortizing Memorandum Accounts (SP U-27-W), is “an accounting device used by a utility to record various expenses it incurs. The utility may later seek authorization from the Commission to recover the recorded amounts by passing them on to consumers in rates.”

The establishment of a new memo account requires a Tier 3 advice letter designation and disposition by resolution. General Rule 7.6.1 of General Order (GO) 96-B states:

Industry Division disposition is appropriate where statutes or Commission orders have required the action proposed in the advice letter, or have authorized the action with sufficient specificity, that the Industry Division need only determine as a technical matter whether the proposed action is within the scope of what has already been authorized by statutes or Commission orders.

In this case, we have not previously required or authorized San Gabriel to establish a memo account to track the costs associated with the implementation of the repair regulations issued by the U.S. Treasury Department in December 2011. Consequently, disposition of AL 423 does not constitute a “ministerial” act and requires disposition by Commission resolution. The Division of Water and Audits has correctly classified AL 423 as a Tier 3 filing.

### **Memo Account Justification**

According to SP-U-27-W, memo accounts track costs that the Commission has directed to be tracked and costs that have been approved to be tracked due to events of an exceptional nature that can be characterized as follows:

- (1) are not under the utility's control,
- (2) could not have been reasonably foreseen in the utility's last GRC,
- (3) will occur before the utility's next scheduled rate case,
- (4) are of a substantial nature in that the amount of money involved is worth the effort of processing a memo account, and
- (5) have ratepayer benefits.

#### **1. The event is not under the utility's control.**

The repair regulations issued as T.D. 9564 in December 2011 and the related regulations issued by the IRS in March 2012 were the result of internal operations at the U.S. Treasury Department and the IRS. Therefore, the causal events impacting San Gabriel's tax status were not under the utility's control.

#### **2. The event could not have been reasonably foreseen in the utility's last GRC.**

San Gabriel's taxes were last addressed in its GRC Application 11-07-005. T.D. 9564 was issued in December 2011 after earlier withdrawals and revisions of previous proposed regulations. San Gabriel could not have been aware of the final language nor the date of promulgation of the repair regulations when it filed its last GRC.

#### **3. The event will occur before the utility's next scheduled rate case.**

The Commission has given authority to Class A water utilities to include expense items in a memo account that it can show will "occur prior to its next rate case, but the amount of which cannot be reasonably estimated for inclusion in its rate case request." The federal regulations were issued in December 2011 and March 2012. In order to capture the tax benefit for ratepayers, the implementation of the repair regulations, and thus the costs associated with their implementation, will need to occur as soon as possible and doing this is in the mutual interest of San Gabriel and its customers.

#### **4. The event is of a substantial nature in that the amount of money involved is worth the effort of processing a memo account.**

The initial implementation costs are of a substantial nature because they represent a significant portion of San Gabriel's latest authorized revenue requirement.

## **5. The memo account has ratepayer benefits.**

The new repair regulations are anticipated to create a significant net income tax deduction to be normalized and passed on to ratepayers in subsequent Commission filings. The benefit of San Gabriel implementing the repair regulations as soon as possible is that the tax benefits will be recognized by San Gabriel which will account for the temporary tax timing differences resulting from implementation of the repair regulations on a normalized (rather than flow-through) basis in order to preserve the benefit of implementing the repair regulations for future rate cases.

San Gabriel is not able to quantify the effects of normalizing the repair regulations at this time as it will not know the expected income tax deductions from the change in the tax related repair regulations until a study is commissioned to estimate the amount of these deductions.

### **Memo Account Approval**

A memo account is not a guarantee of the eventual recovery of expenses and the burden of proof of the reasonableness of the expenses charged to the account is the responsibility of the utility requesting reimbursement of such expenses. If San Gabriel seeks recovery in rates of net costs tracked in the ITRRI-MA in its next GRC, it has the burden of proof to show that: (1) it acted prudently when it incurred these costs; (2) the level of booked costs is reasonable; (3) the costs incurred are not covered by other authorized rates; and (4) it is appropriate for ratepayers, as a matter of policy, to pay for these categories of costs in addition to otherwise authorized rates.<sup>2</sup>

With this caveat, AL 423 is approved and San Gabriel is authorized to establish the ITRRI-MA consistent with Tariff Sheet No. 2170-W attached to this Resolution. We find that this request is compatible with the public interest, sound financial practices, and proper performance by San Gabriel as a public utility.

## **COMMENTS**

This is an uncontested matter that grants the relief requested. Pursuant to Public Utilities Code Section 311(g) (2) this draft resolution was not mailed for comment.

## **FINDINGS AND CONCLUSIONS**

1. By AL 423 filed on January 14, 2013, San Gabriel Valley Water Company (San Gabriel), a Class A water utility, seeks authorization to establish a new memorandum account, the Income Tax Repair Regulations Implementation Memorandum Account (ITRRI-MA), to track the costs associated with implementation of new repair regulations the U.S. Treasury

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<sup>2</sup> See Resolution W-4824, Ordering Paragraph #5.

Department issues and guidance related to these regulations that the Internal Revenues Service issued (collectively referred to in this Resolution as the repair regulations).

2. The new repair regulations provide for several tax accounting changes, one of which accelerates the recovery of repair costs for tax purposes. Pursuant to the repair regulations, utilities will expense repair costs which are normally capitalized.
3. When San Gabriel implements the repair regulations and thus can begin to expense repair related costs, it is anticipated that San Gabriel will claim a significant net income tax deduction.
4. San Gabriel will seek to preserve the anticipated net tax benefits of implementing the repair regulations prior to the next general rate case (GRC) by recording their effects on a normalized basis.
5. San Gabriel will fully normalize the effects of the anticipated net tax benefits as they are realized in accordance with the normalization requirements of the Internal Revenue Code.
6. San Gabriel will incur costs associated with implementing the repair regulations, which will include outside implementation service fees and required accounting system changes, and will record these costs each month in the (ITRRI-MA).
7. The issuance of the repair regulations was not under the control of San Gabriel.
8. San Gabriel could not have reasonably foreseen the expenses associated with the new repair regulations during its last general rate case.
9. The costs of implementing the new repair regulations as soon as possible and will be incurred prior to the establishment of rates pursuant to San Gabriel's next GRC.
10. These costs are of a substantial nature because they represent a significant amount of money to San Gabriel.
11. Currently, San Gabriel is not able to quantify the benefits of implementing the repair regulations but believes them to be substantial in nature and greater than the costs of implementing the repair regulations.
12. San Gabriel should be authorized to establish the ITRRI-MA to track the costs with its implementation of the repair regulations consistent with Tariff Sheet No. 2170-W attached to this Resolution. San Gabriel should be authorized to track the revenues recovered in rates associated with its implementation of repair regulations consistent with Tariff Sheet No. 2170-W attached to this Resolution.

**THEREFORE IT IS ORDERED THAT:**

1. San Gabriel Valley Water Company's Advice Letter 423 seeking authorization to establish the Income Tax Repair Regulations Implementation Memorandum Account attached in Tariff Sheet No. 2170-W to this Resolution for the purpose of tracking costs associated with the implementation of U.S. Treasury Department regulations issued in December 2011 (T.D. 9564) and Internal Revenue Service guidance corresponding to these regulations issued in March 2012 (collectively referred to as the repair regulations), is approved effective today.
2. San Gabriel Valley Water Company is authorized to record costs, which include but are not limited to outside implementation service fees and required accounting system changes, associated with implementing the repair regulations identified in Ordering Paragraph 1 above in the Income Tax Repair Regulations Implementation Memorandum Account consistent with Tariff Sheet No. 2170-W attached to this Resolution.
3. If San Gabriel Valley Water Company seeks recovery in rates of net costs tracked in the Income Tax Repair Regulations Implementation Memorandum Account in its next general rate case, it has the burden of proof to show that: (1) it acted prudently when it incurred these costs; (2) the level of booked costs is reasonable; (3) the costs incurred are not covered by other authorized rates; and (4) it is appropriate for ratepayers, as a matter of policy, to pay for these categories of costs in addition to otherwise authorized rates.

4. This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed, and adopted at the Public Utilities Commission of the State of California on April 4, 2013. The following Commissioners voting favorably thereon:

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PAUL CLANON  
Executive Director



PRELIMINARY STATEMENT (Continued)

O. Income Tax Repair Regulations Implementation Memorandum Account ("ITRRIMA").

1. Purpose

The purpose of this memorandum account is to track the cost of initial implementation of the Repair Regulations and will include (i) outside implementation service fees and (ii) other directly applicable costs, to comply with the U.S. Treasury Department regulations issued in December 2011 (T.D. 9564) and subsequent guidance issued by the Internal Revenue Service ("IRS").

2. Applicability

The entries to the ITRRIMA include the following:

- a. A debit entry shall be made to the ITRRIMA at the end of each month to record any costs associated with implementing the Repair Regulations.
- b. A credit entry shall be made to the ITRRIMA at the end of each month to record the ITRRIMA related cost recovery collected in rates.
- c. Monthly interest expense calculated at 1/12 of the most recent month's interest rate on Non-financial Commercial Paper (AA, 3-month), published in the Federal Reserve Statistical Release, H.15 ([www/federalreserve.gov/release/H15](http://www.federalreserve.gov/release/H15)), or its successor publication (debit or credit).

3. Effective Date

The ITRRIMA will be made effective upon Commission approval.

4. Disposition:

The ITRRIMA will be reviewed in San Gabriel's next GRC. To the extent these costs are less than what is forecasted in rates, San Gabriel will refund the difference to its customers.